C O N F I D E N T I A L SAN SALVADOR 01238
CXSANSAL:
ACTION: ECON
INFO: FCS AMB POL AID DCM

DISSEMINATION: ECON
CHARGE: PROG

APPROVED: CDA:RBLAU
DRAFTED: ECON:BCHRISTENSEN
CLEARED: POL:PLAIDLAW

VZCZCSNI895
OO RUEHC RUEHZA RUEHIN RUCPDOC RUEATRS
DE RUEHSN #1238/01 3041724
ZNY CCCCC ZZH
O 301724Z OCT 08
FM AMEMBASSY SAN SALVADOR
TO RUEHC/SECSTATE WASHDC IMMEDIATE 0248
INFO RUEHZA/WHA CENTRAL AMERICAN COLLECTIVE
RUEHIN/AIT TAIPEI 0084
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC
RUEATRS/DEPT OF TREASURY WASHINGTON DC

C O N F I D E N T I A L SECTION 01 OF 04 SAN SALVADOR 001238

SIPDIS
STATE FOR WHA, EEB
TREASURY FOR DAS ONEILL, LTRAN, SSENICH

E.O. 12958: DECL: 10/28/2028
TAGS: EFIN ECON PGOV ES
SUBJECT: EL SALVADOR FACING SERIOUS FISCAL, LIQUIDITY PROBLEMS

REF: A. SAN SALVADOR 1228
¶B. SAN SALVADOR 1084
¶C. TEGUCIGALPA 937

Classified By: CDA Robert I. Blau, Reasons 1.4(b) and (d)

¶1. (C) SUMMARY. El Salvador faces a short-term fiscal and liquidity crisis, caused by the costs of untargeted subsidies and an inability to place short-term government debt. Approximately $450 million in short-term debt will come due before the end of the Saca Administration on May 31. Banks and investors are no longer willing to roll over short-term debt, preferring to increase liquidity in the face of international constraints and domestic political uncertainty, and lacking confidence in the government's fiscal responsibility. The government's need for new debt in a limited domestic market is also putting upward pressure on interest rates, and its fiscal constraints prevent it from using fiscal policy to combat an economic slowdown or recession. The banking sector warns of the risk of possible bank runs driven both by concerns over domestic political instability and the international financial crisis. While the banking sector has positioned itself well in terms of reserve funds, the banking association is not confident that it can contain a bank run. In the short-run, the Government of El Salvador (GOES) may be able, with assistance from the U.S. Treasury, improve liquidity through addressing structural defects in the financial markets. In the long-run, however, a solution will require improved fiscal discipline, increased confidence between the government and investors, and an accord on external debt between the political parties. Post will report more on possible ways forward septel. END SUMMARY.

¶2. (SBU) Because of the GOES's difficulty in placing short-term debt (reftel A), representatives of the Technical Secretariat to the Presidency, the Central Bank, and the Ministry of Finance requested "emergency" technical assistance from the U.S. Treasury during an October 13 meeting with Treasury DAS Brian O'Neill.

¶3. (SBU) From October 20-22, Treasury's Office of Technical Assistance (OTA) team and Econoff met with GOES officials

including: Manuel Rosales, Director of Fiscal Policy, Investment, and Public Credit, Ministry of Finance; Carlos Salazar, Director of Treasury, Ministry of Finance; Luz Maria de Portillo, President of the Central Bank of Reserve; Sonia Gomez, Director of the Financial System, Central Bank; Luis Aquino, Director of Studies and Statistics, Central Bank; and Guillermo Funes, Deputy Technical Secretary to the President. Outside the government, the team met with: Manuel Enrique Hinds, former Minister of Finance; Dr. Armando Arias, President of ABANSA (private banking association) and Amcham; Macela de Jimenez, Executive Director of ABANSA; Luis Membreno, Economist, Financial Consultant and former advisor to the Minister of Finance; Rafael Barazza, former President of the Central Bank; Carmenza McLean, Country Representative of the Inter-American Development Bank; Gijs Veltman, President of Citibank El Salvador; and Mauricio Choussy, Executive Director of Fitch Ratings in El Salvador.

THE CURRENT SITUATION

¶4. (U) According to Ministry of Finance figures, the GOES has approximately $450 million in Letters of Treasury, short-term (less than one year) debt instruments commonly known as "Letes," that will come due before the end of the Saca Administration on May 31 (reftel A). $133 million of this is due before the end of 2008. In the longer term, the GOES has a $650 million Eurobond due in 2011, as well as normal payments on other international loans.

¶5. (C) The biggest fiscal stress on the GOES is the continued payment of subsidies, especially the subsidies for electricity, propane gas, and bus transportation. When budgeting for the original subsidies, the GOES used estimates based on $70 per barrel oil, but the price was well above that for most of the year, and additional subsides were added for bus transportation. Former Central Bank President Rafael Barazza reported that, from the figures he has been able to obtain, the GOES will spend more this year on subsidies than on public investment. Economist Luis Membreno shared that he'd been told all Ministers were required to cut 10 percent from their budgets this year. Membreno noted that the GOES is still spending "like it's not a dollarized economy and can still print money."

¶6. (SBU) According to Director of Fiscal Policy Manuel Rosales, the $450 million figure for Letes includes all subsidies except the general electricity subsidies, "which are paid by CEL (the state-owned hydro company), not the government." When pressed, Rosales later acknowledged that the GOES was, in fact, responsible for these subsidies as well. Rosales could not, however, provide a figure for all short-term GOES financial obligations.

¶7. (C) Many in the private sector, according to ABANSA/Amcham President Armando Arias, consider the GOES "effectively in default" because of the non-payment of $93.7 million in subsidies owed to energy companies as of October 12, which has dramatically suppressed investor confidence. Former Finance Minister Manuel Hinds and Luis Membreno both described the GOES as "nearly bankrupt" because of the subsidies. S&P downgraded El Salvador's sovereign credit outlook to negative in September, and Fitch Ratings downgraded El Salvador's Ratings Outlook to negative in early October.

¶8. (SBU) Taking on new international debt requires a 2/3 super-majority in the National Assembly, and for the past nearly 3 years, the (left-wing) opposition FMLN has refused to approve any new debt or refinance any existing debt. To get around this political impasse, the GOES created two "trusts," or fidecomisos, one for pension fund debt and one to finance new security, health, and education spending. The legality of the trusts has been challenged in the courts, but Embassy's economic contacts doubt the courts would rule before the 2009 elections. The trusts had a hard time selling their own debt, and, most of it is held by the "semi-autonomous institutions" (e.g., the pension funds).

¶9. (C) While Letes are in law and in theory short-term instruments to be used to smooth out revenue for the year, in practice they have been used instead to finance deficit spending. Barazza noted that this was nothing new -- when he was Central Bank President in the Flores Administration (1999-2004), the GOES at one time had issued more than $900 million in Letes -- but the difference was the current inability to obtain new international financing. The Letes were, in effect, now being used to pay off long-term debt.

¶10. (C) Within the GOES, the Central Bank and Ministry of Finance offered different views of what led to the current situation. Central Bank President Portillo described structural problems within the market for Letes, political risk, and the effects of the international financial crisis. Manuel Rosales, on the other hand, blamed statements by Fitch El Salvador Director Mauricio Choussy, and stated that in his view the U.S. Treasury had promised to "pressure the banks to buy Letes," not to provide technical assistance.

NEW LOAN PACKAGE NO HELP

¶11. (SBU) The National Assembly is currently discussing approval of $950 million in new loans from the World Bank and Inter-American Development Bank. $650 million would be used to pay the 2011 Eurobonds, while $300 million would be used for other debt restructuring and new social programs. The bulk of the loans are back-loaded, so the money would not be available until after the January and March elections.

¶12. (C) IDB Rep McLean said that the structure of the loans was necessary to secure the support of the FMLN, who would not accept new loans that would give the ARENA government $300 million to spend right before the election.

¶13. (C) According to Former Minister Manuel Hinds, the main impediment to the loans had not been the FMLN. Rather, President Saca had resisted any proposal that would let the FMLN clean up its obstructionist image, which is why the proposal was only now going forward. This was now the most opportune time to get the loans approved, because "both parties still believe they're going win the election."

VIEW FROM THE BANKING SECTOR

¶14. (SBU) Overall, the banking sector is still well positioned because it had been preparing for capital flight because of the Salvadoran elections (reftel B). The Central Bank had raised reserve requirements by 3 percent, and the total reserves were effectively at 35% of deposits. The banking sector is still concerned, however, about a possible bank run caused either by worries about the international crisis or the domestic political situation.

¶15. (C) Citibank El Salvador President Veltman said that his bank's decision not to roll over any Letes was part of their liquidity strategy to meet the new reserve requirements, and they had notified the GOES some time ago. He opined that the GOES didn't understand the banking sector was international now, and had to act according to the banks' policies, not the government's wishes. Early on, he noted, the banks, especially Banco Agricola (owned by Bancolombia) had gone ahead and bought a little bit of the "toxic debt" put out by the GOES's two trusts, as "a favor" to the government. Now, however, he regularly receives calls from the GOES asking him to buy Letes, or artificially lower interest rates, or support other proposals "that New York will never approve."

¶16. (C) The weakest link in the banking sector is Banco Hipotecaria, a majority state-owned bank that lends primarily to small and medium businesses and the agricultural sector. According to ABANSA, the private banking association, it is the only bank in their system that has experienced liquidity problems. Former Finance Minister Manuel Hinds attributed the bank's problems to the GOES "forcing the bank to keep

lending at low interest rates, regardless of the current environment." Central Bank President Portillo acknowledged that the GOES had recapitalized the bank by having the "semi-autonomous institutions" (e.g., the pension funds) move deposits to Hipotecaria.

¶17. (C) ABANSA President Arias (strictly protect) said that the banks have been putting out a positive message to keep up confidence in the system. Arias privately expressed doubts, however, that the system could contain a run on the banks. ABANSA had just met with the Technical Secretary and GOES economic team, and was very concerned about overall liquidity in the system, especially what the Central Bank was doing with the banking sector's reserves. There was also not much coordination among the banks about what to do in the event of a bank run. According to Veltman, "it's every bank for itself."

¶18. (C) Manuel Hinds thought the banking sector was stable, but the weak link was in the stock market. The brokerages (all but one of which are owned by banks) had "been acting like banks," promising "higher returns with no risk." The brokerages had also been pooling deposits, instead of maintaining individual accounts, making it harder to pay when a depositor wanted to pull out. He thought savvy investors were already getting out of the market.

¶19. (C) Similarly, Veltman's most likely scenario for a bank run started with the failure of a brokerage. The parent bank would have to step in to support the brokerage, which would weaken the bank's liquidity, potentially damaging confidence in the bank and prompting a run on its assets. On the other hand, Fitch Director Choussy thought the most likely scenario for a run would be "after a big FMLN victory" in the January 18, 2009 legislative elections. The subsequent ARENA "fear campaign," he worried, would prompt a run on the entire system.

POSSIBLE EFFECTS ON THE ECONOMY

¶20. (U) Through the latest data available (August or September), El Salvador's economy continues to grow, especially in the export sector. Remittances have continued to grow, albeit more slowly, in every month except August. For 2008, the GOES projects 4% GDP growth, while the World Bank projects 3.5%. For 2009, the GOES projects 3.5%, while the IMF recently announced a projection of 2.6%.

¶21. (C) In economist Luis Membreno's view, however, El Salvador is not just slowing down, but is likely to head into an outright recession by December or January. Because of the spending on subsidies and inability to place Letes, he added, the GOES does not have the money to engage in counter-cyclical fiscal policy to combat a slowdown or a recession.

¶22. (C) Membreno also noted that the GOES's increasing need for short-term debt, driven by the subsidies, was creating a "crowding out effect" in the domestic credit market and driving up interest rates. With current international credit lines drying up because of the crisis, the government and private sector were competing for resources in the domestic market, and it was becoming a "zero-sum game."

¶23. (C) Fitch Director Choussy, noting the GOES was very critical of Fitch and Choussy personally, warned that Fitch was not the rating agency the GOES needed to worry about. Only Moody's had given El Salvador an investment grade rating, while Fitch and S&P have it one notch below. If Moody's were to downgrade El Salvador, institutions required to hold investment-grade debt would be forced to divest, deepening the GOES's fiscal problems.

COMMENT

¶24. (C) El Salvador's current fiscal crisis is largely

self-inflicted, driven by an insistence on maintaining untargeted subsidies, derided by economists on both the right and left, through the 2009 elections. Even with oil prices falling, the subsidies are not sustainable in the long-run, and the question is not whether they will have to be reduced but when. The subsidies, combined with the GOES's failure to come to an agreement with the electricity companies, have damaged investor confidence in the government. Tightening credit markets and domestic political uncertainty have played a role, too, making banks and investors more risk adverse and less willing to continue to finance what they see as misguided fiscal policy.

¶25. (C) There are, however, a few positive signs. Following an October 21 meeting between President Saca, Manuel Hinds, and Rafael Barazza, Saca appointed Barazza, a widely respected economist and champion of dollarization, to help come up with a solution. Seeking assistance from the U.S. Treasury has also been taken as a good sign by the private sector, assuming that the GOES listens to Treasury's advice. While the Central Bank seems eager for technical assistance, the Ministry of Finance's responsiveness is less certain.

¶26. (C) Treasury's OTA team will offer specific recommendations on how to address the current fiscal and liquidity situation. In the long-run, however, any solution will require a political element. First, the GOES must restore fiscal discipline, especially on subsidies, and not continue to spend like it can still print money. Second, the government and the financial sector will need to sit down and work on ways to restore confidence between the two. Finally, ARENA and the FMLN will need to come to some sort of accord on approving external debt, so that El Salvador can roll over and refinance debt in a normal, fiscally sound way. Post will report more on possible ways forward septel. End Comment.

BLAU